# 5.03 Foreign Currency Exchange Transaction Hedging: Fair Value Hedge

## Hedging Overview

When a forward exchange contract is entered into for the purposes of mitigating or eliminating a risk, it is referred to as a **hedge**. In order to account for a derivative such as a forward exchange contract as a hedge, it must designate the derivative as a hedge and must meet certain requirements. This includes:

- Documenting the relationship between the hedge and the hedged risk,
- Indicating that the hedge is expected to be highly effective, and
- Explaining how the entity measures the hedge's effectiveness.

Assuming a forward exchange contract does qualify as a hedge and hedge reporting is elected, the entity will have to determine if it is a fair value hedge or a cash flow hedge.

## Fair Value Hedges

As the name implies, a fair value hedge protects a company against risks associated with changes in fair values, such as the fair value of a reported asset or liability (hedging against a **recognized** asset or liability on the balance sheet or a **firm purchase commitment**). Since all derivatives are required to be reported at fair value, on each balance sheet date, the carrying value would be increased or decreased, as appropriate.

- The increase or decrease will be recognized as a **gain or loss in the income statement (I/S).**
- A corresponding loss or gain will be recognized on the hedged item in the same period.

The corresponding loss or gain on the hedged item will be recognized, regardless of the normal accounting for the item.

For example, a company is doing business with an unrelated entity that is located in Europe. To enhance the relationship, the company has purchased 100,000 units of the European Company's debt securities, which are publicly held but not actively traded.

- The market price of the debt securities, which has not changed for many years and is not expected to change any time in the future, is €20.
- The spot rate on the date of the investment was 1.30 and the total cost of $2,600,000 was recorded as an available for sale investment (100,000 × €20 × 1.3 = $2,600,000).

The company wishes to protect itself from fluctuations in the fair value of the investment that result from changes in the exchange rate. If, for example, the exchange rate was to drop to 1.20, even though the securities are still selling for €20, their carrying value would be reduced to $2,400,000. Since these are available-for-sale securities, the loss would be an unrealized loss that would be reported, net of tax, in other comprehensive income (OCI).

To protect itself, the company enters into a forward exchange contract to sell 2,000,000 Euros (100,000 units at €20) in the future for $2,600,000. When the company enters into the contract, the exchange rate is 1.30 and the contract has no value.

On the next balance sheet date, the securities are still selling for €20 per unit, but the forward exchange rate has dropped to 1.25. The following would occur as a result:

- The forward exchange contract would now have a fair value of approximately $100,000 since the company has the ability to sell Euros worth $2,500,000 for $2,600,000.
- The fair value of the available for sale investment would be reduced to $2,500,000, which is the fair value of the investment in dollars. The entries would be:

| | | |
|---|---|---|
| Forward exchange contract (B/S) | 100,000 | |
| **Gain** on forward exchange contract (I/S) | | 100,000 |
| **Loss** due to decline in value resulting from change in exchange rate (I/S) | 100,000 | |
| Investment in AFS debt securities (B/S) | | 100,000 |

Even though the loss due to decline in value of the available for sale securities would ordinarily go into OCI, it is reported on the income statement due to the use of hedge reporting.

If, as an alternative, the securities had changed in value due to both a change in the securities price and a change in the exchange rate, only the portion related to the change in the exchange rate would be reported using hedge accounting. The residual gain or loss would receive the accounting treatment that was normal for the hedged item.

If, for example, in addition to the exchange rate dropping to 1.25, the unit price increased to €21, the securities would now have a value of (100,000 × 21 × 1.25) $2,625,000.

The entries would be:

| | | |
|---|---|---|
| Forward exchange contract (B/S) | 100,000 | |
| **Gain** on forward exchange contract (I/S) | | 100,000 |
| **Loss** due to decline in value resulting from change in exchange rate (I/S) | 100,000 | |
| Investment in AFS debt securities (B/S) | 25,000 | |
| Unrealized gain due to increase in value of AFS securities (OCI) | | 125,000 |